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STATE FOR WHA/CAR/ (WBENT), WHA/EPSC (JSLATTERY)

SANTO DOMINGO FOR FCS AND FAS

TREASURY FOR L LAMONICA

E.O. 12958: NA
TAGS: ECON EFIN JM
SUBJECT: SOARING INFLATION THREATENS JAMAICA'S MACRO-
ECONOMIC STABILITY

REF: KINGSTON 386

¶1. Summary: Less than two months after the IMF gave Jamaica high marks for stabilizing the economy, spiraling inflation is again threatening macroeconomic stability. Inflation, which reached almost 14 percent last year and has already jumped to 7.4 percent for the first four months of the fiscal year (Note: Jamaica's fiscal year runs from April to March) shows no sign of abating, given the continued rise in food and oil prices and the pending increases in utility rates and transportation costs. The price increases have prompted Finance Minister Omar Davies and Bank of Jamaica Governor Derrick Latibeaudiere to concede that the single-digit target for the fiscal year is unlikely to hold. This admission has not gone down well with trade unions, which have signaled their intention to seek higher wage increases when the wage restriction agreement with the GOJ ends in 2006. The galloping inflation and inflationary expectations have also halted efforts to reduce interest rates, which could have repercussions for the MOU and by extension macroeconomic stability and investor confidence. End summary.

¶2. Just six weeks after the IMF gave Jamaica high marks for stabilizing its economy, spiraling inflation is threatening to throw the GOJ's financial program off track. Although inflation galloped to 13.7 percent last year, the memorandum of understanding (MOU) between the GOJ and trade unions remained intact because the bulk of the price increases were blamed on the ravages of Hurricane Ivan, which dealt a serious blow to the economy. However, things show no sign of subsiding as inflation has jumped to 7.4 percent for April to July 2005 and 8.9 percent for January to July 2005. The price spiral has prompted Finance Minister Omar Davies and BOJ Governor Derrick Latibeaudiere to concede that inflation could surpass 15 percent this fiscal year (above 9 percent target). This would be the first time since 1996 that inflation would surpass the 15 percent level. Davies and Latibeaudiere have argued that a number of exogenous shocks have fuelled the latest bout of price instability, as core inflation (due to increased money supply) rose by a meager 1.7 percent during the period. Chief among the reasons cited are increasing oil prices; higher food prices; rising transportation and electricity cost; and, the tax measures implemented in April and May.

¶3. The admission by Davies and Latibeaudiere has angered trade unionists, who were promised single digit inflation as a condition for agreeing to a wage restraint. Unions have signaled their intention to seek double digit wage increases when the wage restriction agreement with the GOJ ends in March 2006. Lambert Brown of the University and Allied Workers Union has suggested that workers' standard of living has been significantly eroded and, whenever salary negotiations commence, unions will push for sufficient adjustment in salary to meet the needs of workers. He stated that most employers could afford the increases, pointing to the healthy profit of the Mirant-owned Jamaica Public Service (JPS), which reported profits of USD 8 million for the first three months of 2005, and most companies listed on the local stock exchange. However, the Jamaica Employers Federation has countered by arguing that employers cannot afford the increases contemplated, as the inflationary spiral was also affecting them.

¶4. Inflation could actually surpass the 15 percent mark suggested by the economic authorities, given that additional inflationary impulses are expected to emanate from increased utility rates. The Office of Utilities Regulation (OUR) has agreed to grant JPS a 7.5 percent increase in electricity rates effective September 2005 and a seven-cent increase per kilowatt-hour effective October 2005 to recover rehabilitation costs associated with Hurricane Ivan. The OUR has also approved a 67 percent hike in bus fares effective August 2005 to cut the company's almost USD 41 million deficit, while taxi

operators were granted a 25 percent increase in rates. There is also a request before the OUR for an increase in water rates later this year. These announcements have drawn the ire of trade union leaders who met with GOJ officials to express their frustration with the general price increases and the bus fare increase in particular. The trade unions got the GOJ to agree to an exemption for public sector workers in the Kingston Metropolitan area.

¶5. The continued rise in international oil prices is also expected to provide further impetus for inflation, as studies conducted by the BOJ show that the country's inflation rate climbs by a quarter of a percent for every USD 1 jump in the price of oil. Additionally, rising oil prices could have a negative impact on the balance of payments, the exchange rate and economic growth, thereby fueling another bout of macroeconomic instability. Oil alone is expected to cost Jamaica USD 1.2 billion in 2005, and with exports falling this will put pressure on the stock of reserves (USD 2.1 billion). The surge in prices will also militate against fiscal policy as the budget was predicated on oil prices of USD 47 per barrel, but prices are now USD 67 per barrel and climbing. The runaway inflation is also hampering the BOJ's efforts to reduce interest rates, as evidenced by the most recent interest rate auction when the rate paid on benchmark 30-day repurchase agreement rose by 0.15 percent.

¶6. Comment: The inflation spiral is not expected to subside anytime soon, as additional impulses will come from the increased price of agricultural commodities due to supply shortages arising from adverse weather conditions associated with the last two hurricanes; the lagged effects of increased taxes; and, increased water rates later this year. This could impact negatively on the MOU, which hinges on the moderation in inflation. In fact, most trade unions have already reacted negatively to approaches by the GOJ to extend the wage freeze when it expires in 2006. This will have a deleterious effect on fiscal policy and investor confidence unless the GOJ can devise policies during the current fiscal year to temper the wage bill following the expiration of the MOU in 2006. However, even if a new pact is negotiated, workers not bound by the MOU will be clamoring for higher wage increases to compensate for lost purchasing power. This will in turn feed into inflation and the attendant uncertainty will provide further impetus for inflationary expectations.

¶7. Comment (cont'd): Rising prices will also impact the BOJ's plans to further reduce interest rates, as people will be unwilling to accept the current negative real rates of interest. This could ignite a bout of macroeconomic instability, as investors shift from local to foreign assets building up demand pressure on the foreign exchange market. The resulting depreciation would then provide further fuel for price increases. On the positive side, the BOJ has over USD 2.1 billion in foreign reserves at its disposal to at least satisfy any build up in demand for foreign exchange in the short term. Additionally, if it is any consolation, the recent price instability has been driven by cost-push factors and not the problematic core inflation of the early 1990s. End comment.

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